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Intergovernmental policy co-ordination and finance

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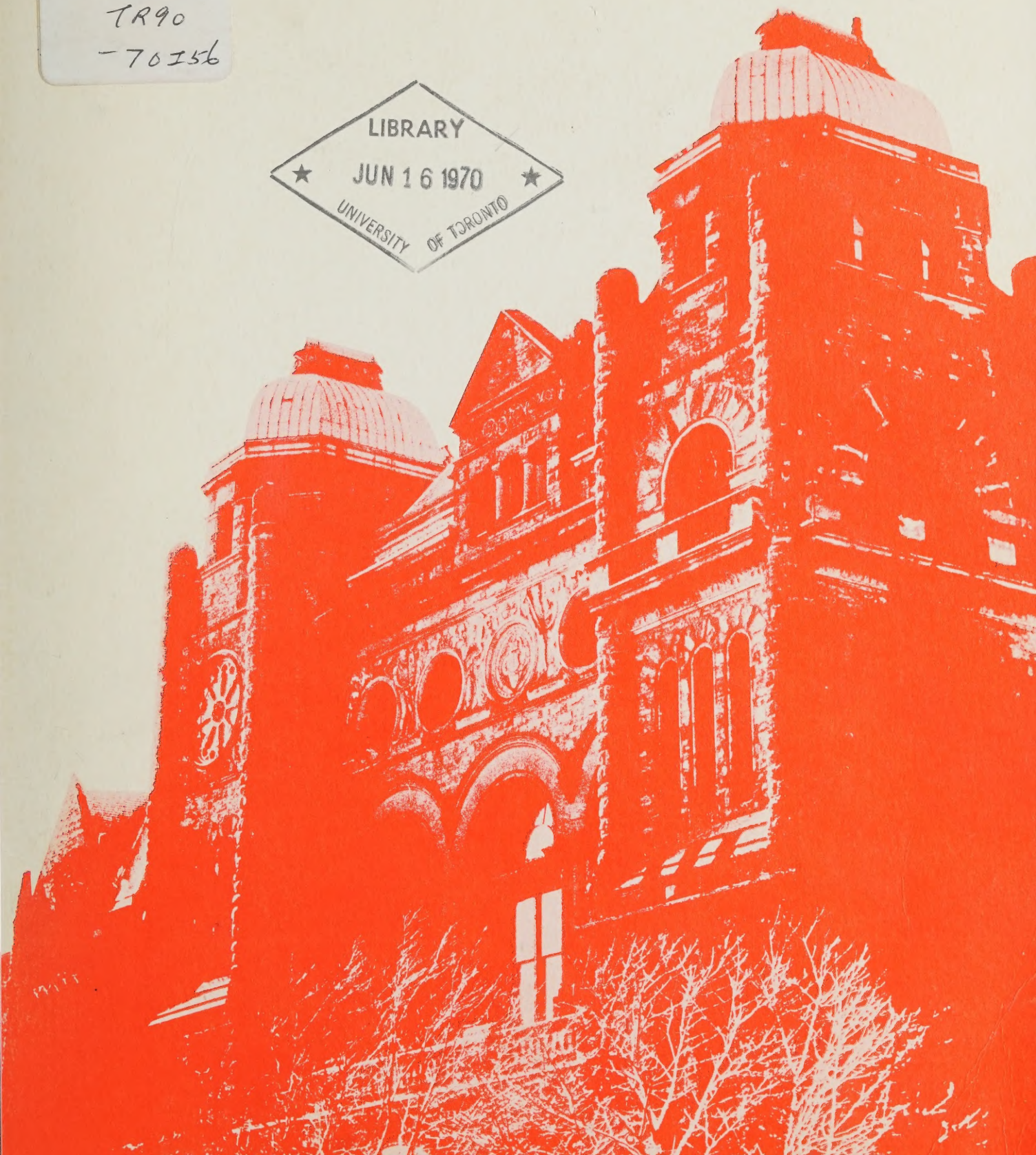
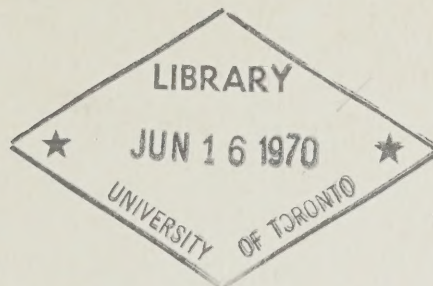
Department of Treasury and Economics
Taxation and Fiscal Policy Branch

Ontario

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Intergovernmental policy co-ordination and finance

Reprinted Staff Papers



ONTARIO

Department of Treasury and Economics
Taxation and Fiscal Policy Branch

International
Policy Co-ordination
and Finance
Report



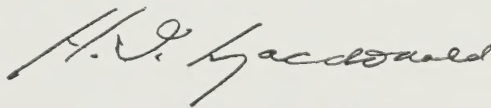
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Toronto 5, Ontario

Preface

This volume contains three working papers which have been presented by Ontario delegates to various federal-provincial conferences of officials over the past few years. Together they represent a series of constructive proposals advanced by Ontario officials on the problems of intergovernmental fiscal policy co-ordination, tax reform and finance. They are reprinted at this time to provide the public with some insight to the type of work undertaken by Ontario's officials in support of discussions at the ministerial level.


It should be noted that these papers were written to meet the agenda requirements of particular conferences and should be taken in each case as partial contributions only to the development of new federal-provincial arrangements. Also, since the papers are reprinted as they were presented originally, they represent stages in the continuing development of our ideas. Many of the suggestions in these papers, however, have been carried forward and developed further in the accompanying volume *Ontario's Proposals for Fiscal Policy Co-ordination in Canada*.

The three papers contained in this volume were prepared in the Taxation and Fiscal Policy Branch of the Ontario Department of Treasury and Economics.

A handwritten signature in dark ink, appearing to read 'H. I. Macdonald', with a stylized, flowing script.

H. I. Macdonald
Deputy Treasurer of Ontario and
Deputy Minister of Economics

May 1970



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NOTES ON THE PURPOSE AND OBJECTIVES OF THE TAX STRUCTURE COMMITTEE¹

Introduction

1. At the federal-provincial Constitutional Committee meetings in February, 1969, it was agreed to reconvene the Tax Structure Committee to consider intergovernmental financial arrangements. In April, the Continuing Committee of Officials on Economic and Fiscal Matters met to plan the implementation of the Constitutional Committee's resolution. At this meeting a proposal to update the 1966 TSC projections of federal-provincial expenditures and revenues met with general agreement.

2. In agreeing to participate in the exercise, however, the Ontario delegation urged strongly that the purposes and uses of the projections should be precisely defined before proceeding with data collection and compilation. This suggestion was based on two points. First, it was noted that the 1966 projections did not result in any changes in intergovernmental financing arrangements. Second, unless the nature of the problems to be resolved are defined it cannot be assumed that the projections would provide a basis for their solution. For both reasons it was thought that explicit definition of the analytical purposes of the exercises was necessary to justify the commitment of scarce staff resources.

3. During the past few months federal and provincial officials have met to prepare the projections as instructed. The projections are now virtually complete, but the basic question of their value and use still remains. It is, therefore, a matter of some urgency that the objectives of the TSC and its attendant Continuing Committee should be clarified. These notes contain the Ontario delegation's suggestions on how the committee's work might be focused on two groups of problems in the area of intergovernmental financial co-operation. These are:

- (a) Intergovernmental Fiscal Arrangements
- (b) Economic and Fiscal Policy Co-ordination.

Intergovernmental Fiscal Arrangements

4. This area generally covers the wide range of intergovernmental arrangements which govern the distribution of financial resources. Conventionally, these are: explicit and implicit tax sharing, cost sharing, and

¹Submitted to the Continuing Committee on Economic and Fiscal Matters, St. John's, Newfoundland, September 1969.

interprovincial equalization payments and policies. The essential purpose of these arrangements is to ensure that the financial capacity of federal and provincial-municipal governments match their respective expenditure responsibilities as closely as possible.

5. The original TSC projections were undertaken to provide an objective basis for further adjustments in federal-provincial tax sharing after 1967. It is against this background of experience with the 1966 TSC projections that the purpose and value of the new exercises must be considered. In this connection, the two basic reference points are, first, the refusal of the federal government since 1966 to consider increased fiscal transfers to the provinces, and, secondly, the development of the Principle of Equal Access under which each level of government is to be responsible for raising revenues to finance required expenditure increases. If these developments represent the new framework within which the problem of intergovernmental fiscal arrangements must be approached, it is unlikely that any new projections will form the basis for changes in the division of existing financial resources. They may serve as a useful means of defining the size and form of the financial problems confronting each level of government. But the main question is how, under a regime of independent taxation, the various governments will move to solve their financing problems, and, importantly, how these actions can be prevented from resulting in the destruction of a uniform Canadian tax structure.

6. The existing system of tax sharing has proven defective in the allocation of fiscal resources between the federal and provincial-municipal governments. Nevertheless, it has provided a framework for the maintenance of a reasonably uniform tax structure across the country. Paradoxically, the equal access approach offers an opposite set of advantages and disadvantages. The ability to use all tax fields would seem to be a simple way of ensuring that all governments can finance required expenditures. But it also involves the danger of unco-ordinated tax actions resulting in serious interprovincial tax differences and countermanding policies as the provinces move to meet different expenditure demands and achieve different social and economic objectives. While the need to remain economically competitive may work to contain tax levels and foster interprovincial co-operation, it may also result in measures designed to compete for economic activity and export tax incidence.

7. The above points suggest that insufficient attention has been given to the implications of the equal access approach to intergovernmental finance in the vital area of tax structure co-ordination. Ontario discussed this matter at some length in the paper *Intergovernmental Finance and Ontario's White Paper on Provincial-Municipal Taxation Reform*, which it tabled at the June, 1969, Constitutional Committee meeting. The Ontario delegation now suggests that the Tax Structure Committee should tackle

this problem of tax structure co-ordination as a major area of concern, and work to the development of new methods and mechanisms for the maintenance of the highest possible degree of consistency in taxation across Canada.²

8. It is believed that the Tax Structure Committee could best work to this objective in two main ways. First, it could seek to develop new guidelines and conventions within which independent tax actions should take place. Second, it could serve as an active forum for the examination of governments' tax actions and proposed tax reform programs. Concentration by the TSC on such a tax structure co-ordination role could produce some very positive results, such as:

- recognition of the wider interprovincial implications of particular tax changes within the total tax framework;
- recognition of economic implications and tax exporting properties of certain tax policies;
- providing insight into which taxes are best used for particular types of objectives by federal and provincial-municipal governments;
- setting out the essential requirements for complementary and non-competitive tax actions;
- promotion of intergovernmental tax structure harmonization by providing a continuing forum for discussion and examination of specific tax actions and proposals.

9. It is not necessary to embark on years of study before productive discussions of this sort can take place. There are a number of urgent intergovernmental tax problems which could be considered immediately and separately. The main requirement is a willingness on the part of all governments to discuss the extra-jurisdictional aspects of their systems and actions and, particularly, to allow adequate opportunity for discussion before changes are made. Alternatively, where budgetary requirements prevent prior discussion, it requires a willingness to introduce modifications in the light of *ex post* examination.

10. Advance notice and discussion of proposed tax changes are particularly important in the case of multi-tax reforms of the order contemplated by the various tax commissions. In this connection, Ontario's tax reform program represents a case study of how a province can reconstruct the

²In *Intergovernmental Finance and Ontario's White Paper on Provincial-Municipal Taxation Reform*, it was suggested that a Ministerial Policy Co-ordination Committee replace the present Tax Structure Committee and the Ministers of Finance meetings. It also was suggested that much of the detailed work on tax data collections, research, and development of tax guidelines could be delegated to a federal-provincial tax commission, which could also be responsible for the administration of intergovernmental financial arrangements. See this volume, p. 13 ff.

bases of provincial and municipal finance. However, Ontario's white paper was purposely drawn up to allow the maximum possible room for consultation and negotiation with the federal and other provincial governments. Ontario's proposals for capital gains and gifts taxation, and succession duties depend directly on agreement with the federal government on joint action. It was also emphasized that Ontario would not proceed with other key elements of the program—such as the establishment of a provincial personal income tax system—until after the publication and consideration of the federal government's white paper. Ontario has expressed an urgent desire to discuss tax reform with the federal government in order to ensure the complementarity of provincial and federal actions. We are pleased, therefore, that the federal government now intends to table its white paper before proceeding with draft legislation.

Economic and Fiscal Policy Co-ordination

11. At the January, 1968, Ministers of Finance meeting there was a general recognition of the need to establish effective mechanisms for intergovernmental budgetary consultation. This promising start, however, has been advanced no further and certainly has not led to the development of operational forms of fiscal and economic policy co-ordination. Yet this is the direction in which we should be moving, particularly in view of the new climate of unilateral expenditure decisions and independent taxing. The paper Ontario tabled at the June, 1969, Constitutional Committee meeting discussed the problem of co-ordination and set out some preliminary views on the kind of changes needed to achieve co-ordinated intergovernmental policy action. In the following points, we have attempted to elaborate on these views and set out in greater detail the kind of institutional mechanism, information exchanges and work programs necessary to develop operational policy co-ordination.

12. While the need for intergovernmental policy co-ordination is generally recognized, insufficient attention appears to have been paid to the potential for achieving co-ordinated economic and fiscal policy. In Ontario's view the increasing sophistication of budgetary techniques, the advent of program budgeting and the development of more policy-receptive tax structures at the provincial level over the past few years have substantially broadened the scope for effective fiscal and economic policy co-ordination (and conversely, for countermanding or perverse policies).

13. Intergovernmental policy co-ordination which will be productive of practical results requires more formal and rigorous mechanisms than the present loose system of the Tax Structure Committee and the Ministers of Finance meetings supported on an *ad hoc* basis by the federal-provincial Continuing Committee on Economic and Fiscal Matters. As Ontario stated in its June submission to the Constitutional Committee, we believe that

these committees should be replaced by a Ministerial Policy Co-ordination Committee responsible for the complete range of intergovernmental economic and fiscal policy co-ordination, supported by a strengthened body at the senior civil service level and aided by a permanent federal-provincial secretariat.

14. The information inputs required to agree on and secure maximum governmental leverage for fiscal and economic purposes are much more extensive than the present inputs (economic forecasts, aggregate financial projections). In particular, there is a need for :

- a more intensive and substantial effort in economic forecasting at both the national and regional levels, with ample time for all participants to analyze and discuss the results. This involves improved federal-provincial liaison in the forecasting function, together with much greater detail on sectoral and regional disaggregations than in the past. It also requires informed dialogue on how the economy is performing and where the major problems lie ;
- consideration of anticipated monetary policy including the regional implications of changing monetary conditions ;
- consideration of public borrowing, debt management and cash reserve policies, and utility financing ;
- breakouts of federal revenues and expenditures by province, so that provincial economic and fiscal planning can take federal actions into account ;
- consideration of tariff and trade policies and analysis of how changes in such policies affect provincial economies ;
- submission by each government of its expenditures and investments by priority ranking ;
- maximum disclosure of budgetary intentions by all governments.

These represent the minimal inputs if there is to be frank and informed discussion, progress towards achieving a consensus on appropriate economic and fiscal policies, and, hopefully, some general agreement on how such policies can best be implemented.

15. The development of more operational forms of policy co-ordination also will require specific supporting studies to provide a sound background for joint decision-making. For example, major overriding problems such as inflation should be thoroughly researched in order to pinpoint causes, effects and possible corrective strategies. Similarly, there should be an ongoing research program studying the economic and financial implications of new and emerging public sector objectives such as pollution control and differential fiscal policy. Study of the leakages and linkages between provincial (or regional) economies is another area where information and insight

will be vital. Perhaps the Economic Council and DBS could be asked to provide such background studies. In any case, Ontario believes this kind of objective research is essential if there are to be sound decisions on what economic and fiscal measures are most appropriate to achieve the above objectives and which level of government should do what.

16. Given a functional structure, full two way information exchanges and purposeful background studies, Ontario believes that major progress can be made toward achieving intergovernmental policy co-ordination. The potential gains (both individual and collective) of achieving a workable system of economic and fiscal policy co-ordination are many, including:

- rationing of public resources according to an agreed package of public sector priorities ;
- mutually supporting debt management and borrowing policies ;
- co-ordinated tax changes to serve the ends of mutually agreed fiscal needs.

INTERGOVERNMENTAL FINANCE AND ONTARIO'S WHITE PAPER ON PROVINCIAL-MUNICIPAL TAXATION REFORM¹

Introduction : Origins and Perspective

1. At the sixth meeting of the Continuing Committee of Officials on the Constitution, the Ontario delegation tabled its government's recent white paper on provincial-municipal taxation reform for consideration by the members.² The purpose of these notes is to outline briefly what is thought to be the relevance of the white paper to current constitutional discussions, and to the problem of intergovernmental finance in particular.

2. The white paper may be given perspective by a brief consideration of two basic approaches to intergovernmental finance which have been recognized in recent years. In general terms, these may be cited as follows :

(a) *Co-ordinated Taxation*. This approach involves a system in which at least the main areas of federal-provincial taxation are co-ordinated through federal control, with periodic revisions in the division of the relevant revenues between the federal and provincial governments.

(b) *Independent Taxation*. This approach involves a system in which each level of government raises its own taxes within its constitutional limits, in order to finance its own expenditure requirements.

3. The co-ordinated taxation approach is roughly descriptive of intergovernmental finance since the Second World War. During this period the federal government has controlled the important fields of personal and corporate income taxation, and to some extent estates taxation as well. On the one hand, those provinces which signed collection agreements have received explicit abatements ; while those which operated separate collection systems have been allocated implicit tax room and have generally conformed to federal structures. On the other hand, the federal government has been able to use the personal and corporate income tax fields for its own fiscal policy purposes.

¹Tabled at the Federal-Provincial Constitutional Committee, Ottawa, June 1969.

²See, Hon. C. S. MacNaughton *Ontario Budget 1969*, Ontario Dept. of Treasury and Economics, Taxation and Fiscal Policy Branch, Queen's Park. The white paper appears as Budget Paper B, "The Reform and Taxation and Government Structure in Ontario," pp. 53-70, and is reprinted in *Ontario's Proposals for Fiscal Policy Co-ordination in Canada*.

4. During the 1960's this system of federal-provincial tax sharing has come under increasing pressure. While the provincial shares of total personal income, corporate income and estates tax revenues were increased to 28, 20 and 75 per cent respectively, the re-allocation has been insufficient to meet the heavy expenditure demands confronting the provinces. This has generally had a two-fold effect:

- (a) The provinces have raised taxes regularly in those fields lying outside of federal-provincial tax sharing agreements.
- (b) The provinces have resorted to continuous debt financing.

5. It is against this background that Ontario's white paper on provincial-municipal taxation reform is relevant to the current constitutional discussions. This paper is concerned with two main aspects of the Ontario white paper in a constitutional context. First, although the recommendations of the white paper can be implemented within the present constitutional framework, they also specify the requirements for provincial-municipal tax reform under any new constitutional arrangements involving the development of the principle of free access. Second, the paper is concerned with new mechanisms for federal-provincial co-ordination on fiscal and taxation matters, which will be necessary whether or not the present constitution is amended.

6. This paper does not attempt to deal with the problem of how far the principle of access should be carried or to what extent constitutional changes in the taxing power should be contemplated. While the principle of free access can be taken as a general objective, it is quite conceivable that for practical reasons it might not be extended to its logical extreme. For example, there appears to be general agreement that the federal government should have exclusive control over customs duties, both to secure international agreements and to avoid the emergence of inter-provincial trade barriers. Similarly, it might be necessary to restrict federal access to property taxation, other than for purposes of wealth taxation generally, because of the critical importance of this form of taxation for municipal finance.

Main Objectives of Ontario's Tax Reform Program

7. The program for provincial-municipal taxation reform set out in Ontario's white paper has three main objectives. It would be useful at this point to outline briefly and explain these principles.

- (a) To increase the revenue productivity of the overall provincial tax system in a balanced and equitable manner. This has at least two important implications:
 - insofar as the province's total revenues have a low elasticity factor, its growth capacity must be increased to approximate

more closely the anticipated growth in essential expenditure requirements.

—insofar as continued and increased use must be made of non-income tax fields, it must be as part of an overall tax strategy rather than through *ad hoc* changes.

(b) To co-ordinate tax changes across the broadest possible spectrum of provincial and municipal taxes, in order to control their impact on economic activity and the distribution of individual tax burdens. Given the points mentioned under (a) (above) the main objective here is the rationalization of municipal property and retail sales taxation.

(c) To achieve the maximum possible degree of harmonization of Ontario's provincial-municipal tax system with that of the federal government and other provinces. This implies the establishment of effective mechanisms for achieving common agreement to:

—avoid interprovincial tax competition, and extraterritorial taxation;

—minimize the compliance costs and administrative complexity of taxation;

—control the growth of the total government sector;

—allow the maximum flexibility in the use of taxation for fiscal policy purposes.

Main Features of Ontario's Program in a Federal Setting

8. Given the main principles and objectives of Ontario's tax reform program, the white paper contains a number of proposals which are of particular relevance to the development of new forms of federal-provincial financial relations. In particular, it contains three major recommendations for a significant realignment of federal-provincial tax fields. These are as follows.

Personal Income Taxation

9. Undoubtedly, the most important feature is Ontario's intention to establish its own personal income tax system. This is considered to be essential in order to increase the revenue productivity of its total revenues, and to provide a vehicle for relating commodity and property tax burdens to individuals' ability-to-pay, as well as consolidating provincial transfer payments to individuals.

10. Under the present collection agreement with Ottawa, Ontario's participation in the design and use of the personal income tax system is extremely limited in terms of its ability to achieve its tax reform objectives. At present, the provinces can increase their use of the field—and thence implicitly the overall productivity and progressivity of their total tax mixes—

by instructing the federal government to apply across-the-board surtaxes to the standard federal rates. This mechanism is, however, seriously defective in at least two important respects :

- (a) *Progressivity.* While the income base and progressive rate structure may be initially acceptable in equity terms, there is a distinct danger that successive increases in provincial surtaxes would eventually overload the system to the point where the burden on lower and middle income classes would become punitive.
- (b) *Integration.* The confinement of the provinces to applying across-the-board rate increases denies them the ability to control the incidence of other and generally regressive provincial taxes through credits or exemptions against provincial income tax liabilities.

11. This situation is exacerbated by a further weakness in the present federal-provincial income tax system. This concerns the exclusive right of the federal government to apply separate taxes against the taxable income base. The recent Social Development Tax had the effect of undermining the progressivity of the overall system in a way which inevitably reduced the ability of the provinces to apply rate increases.

Corporate Income and Estate Taxation

12. The second main feature is Ontario's proposal that it turn over the corporate income tax and succession duties fields to federal administration, provided satisfactory arrangements can be negotiated on tax sharing and provincial participation in the design and use of the taxes by the federal government. In addition, as a companion to estate taxation, Ontario contends that the provinces should be granted similar rights in respect of federal gift taxation.

13. The proposed transfer of the corporate income tax field is based on two factors :

- (a) *Compliance and Administrative Efficiency.* At present most of the provinces have collection agreements with Ottawa, while those provinces with separate systems very largely conform to the federal system. A single centralized authority is an obvious rationalization.
- (b) *Avoidance of Interprovincial Tax Competition.* It is commonly assumed that the location of corporate activity is highly sensitive to interjurisdictional differences in corporate taxation. Insofar as the corporate income tax is probably the most important form of corporate taxation, it follows that its "neutralization" under federal control would be an important safeguard against interprovincial tax competition for corporate activity.

14. Similar reasons apply to succession duties. First, the federal government's proposed changes in the Estate Tax effectively pre-empts

possible provincial moves in the field. Second, the practice by some provinces of making estate tax rebates to their residents is symptomatic of a basic dissatisfaction with this form of taxation. Consequently, Ontario is in favour of a complete overhaul of present systems to avoid the danger of significant interprovincial differences in estates taxation leading to the development of "tax havens" in Canada. The solution of this problem is not easy. As a first step the abolition of Ontario's succession duties would have the effect of reducing the complexity of death taxation in Ontario.

Capital Gains Taxation

15. Third, Ontario advocates the establishment of a federal-provincial capital gains tax system. On the one hand, such a move is an obvious part of any serious move to improve the overall equity of the Canadian tax system. On the other hand, it could be a part of an alternative approach to wealth taxation, to allow estates taxes to be de-emphasized or abolished. Two further points might be made:

- (a) To avoid interprovincial differences, the capital gains tax should be administered by the federal government.
- (b) As part of the general area of income taxation, the revenues should be subject to federal-provincial tax sharing as in the case of personal income taxation.

New Mechanisms for Federal-Provincial Co-ordination

16. The proposed realignment in federal-provincial tax administration contemplated in the Ontario white paper does not, however, materially change the basic requirements for achieving intergovernmental financial co-ordination. Insofar as all governments are taxing essentially the same sources, it remains imperative to co-ordinate tax efforts in order to control the distribution of taxation burdens within an overall agreed-upon concept of the desirable size of the government sector. The latter requires the development of an operational system of intergovernmental priority setting, while the former essentially involves the maintenance of common tax conventions and co-ordinated fiscal, tax structure and administrative policies.

17. The Ontario white paper implies an important change in the approach to the problem of federal-provincial financial co-ordination. This may be simply cited as a change to achieve harmonization through horizontal rather than through vertical tax co-ordination.

Vertical Tax Co-ordination

18. Under the previously cited co-ordinated taxation approach (para. 2a), the integration of tax systems has been confined to the corporate, personal and estate tax fields. While this ensured a high degree of vertical

conformity in the operations of the two levels of governments in these fields, it has two main weaknesses:

- (a) The great bulk of commodity and other taxes at both federal and provincial levels have been developed largely without any regard to the overall pattern of taxes at each level and between levels of government.
- (b) The whole field of municipal finance and taxation has been largely ignored, despite the obvious fact that municipal property taxation has become an important component of the total tax system.

Horizontal Co-ordination

19. In contrast to the present situation, the white paper implies the possibility of achieving a much wider range of integrated taxation at the provincial-municipal level. That is, the establishment and use of the provincial income tax system as a means of controlling the incidence of such large tax fields as the retail sales, health premium and municipal property taxes (with the possible extension to transfer payments and other specific taxes), would have the effect of creating an integrated system at the provincial-municipal level. If the federal government were to achieve a similar integration among its major tax fields, the result would be the establishment of two parallel tax structures, each internally balanced and consistent within itself. If the means could then be found to achieve a measure of co-ordination between federal and provincial structures, the total degree of tax co-ordination in Canada would have been materially increased over the present partial integration.

20. In the white paper and in several other statements, the Ontario government has made a number of suggestions concerning the way horizontally integrated federal and provincial-municipal tax systems could be effectively co-ordinated. In particular, new institutional arrangements are necessary to deal with two main functions. The first concerns inter-governmental policy co-ordination to ensure maximum use of total governmental leverage for fiscal policy purposes, and the rationing of scarce financial resources within agreed limits to the growth of the total governmental sector. The second involves the need to achieve a high degree of co-operation in taxation matters, centering particularly on the avoidance of interprovincial tax competition and establishment of agreed criteria for the use of tax fields jointly occupied by federal and provincial governments, as well as for the development of tax structures generally.

A Ministerial Policy Co-ordination Committee

21. The first function requires the establishment of more formal and rigorous mechanisms for intergovernmental policy co-ordination in place of the present loose system. In recent years this work has been largely

conducted at the ministerial level through the Tax Structure Committee and meetings of Ministers of Finance and Treasurers, supported on an *ad hoc* basis at the civil service level by the federal-provincial Continuing Committee on Economic and Fiscal Matters. Apart from the confusion in demarcation among the committees, their work on the whole has been of a fragmented and limited-purpose nature. Since 1966 the Tax Structure Committee has been inactive, while recent proposals for its revival have centred on renewed *pro forma* expenditure-revenue projections with uncertain policy relevance as well as possible discussion of tax reform proposals. Finally, the promising start in budgetary consultation at the January 1968 Ministers of Finance meeting has not led to the development of more operational forms of policy co-ordination.

22. In Ontario's view these committees should be replaced by one ministerial committee responsible for the complete range of intergovernmental economic and fiscal policy co-ordination, supported by a strengthened body at the senior civil servant level and aided by a permanent federal-provincial secretariat. In terms of linear development, this system should be an extension of the approach of the Ministers of Finance meetings towards budgetary consultation, rather than as a continuation of the Tax Structure Committee program with its more limited approach to intergovernmental finance. More particularly, the new system should be concerned with two interrelated areas.

Fiscal Policy Co-ordination

23. On the one hand, the continued growth in the relative economic importance of provincial-municipal operations emphasizes the urgent need to avoid contrary federal and provincial actions. On the other hand, the development of more sophisticated budgetary techniques and more policy-receptive tax structures at the provincial level point to a very real possibility of achieving co-ordinated intergovernmental policy action. Work in this area would include:

- (a) Development of a framework for establishing common intergovernmental policy objectives in respect of economic growth and stability. The Economic Council and other institutions have done much work in this area of a general and conceptual nature, but it remains to develop explicit and operational devices for governmental use.
- (b) Delineation of the scope and methods by which federal and provincial leverage can be used within a common and consistent framework. In what ways and situations can provincial actions be used to support federal policies, and *vice versa*? What are the differential effects and possibilities of federal and provincial actions within and between regions? Apart from a general need for more information and models concerning the interprovincial

structure of the economy, these questions also point to a need for more information on the form and implications of federal expenditure and financing operations, as a basis for selecting federal-provincial policy packages to achieve objectives.

Tax Structure Co-ordination

24. The second area of concern which would be appropriate to the ministerial policy co-ordination committee would be that of intergovernmental tax structure harmonization. One of the major weaknesses of the recent federal and provincial tax commissions was that they tended to confine themselves to the problems of tax reform at the level of their respective governments, with inadequate consideration of the larger intergovernmental framework. Hopefully, however, provincial proposals such as those contained in the Ontario white paper and the federal government's forthcoming white paper will provide a viable range of options for the development of a workable intergovernmental tax system.

25. In Ontario's view it is important that the question of intergovernmental tax reform should not be treated in isolation of the broader questions of policy design and co-ordination as a whole. The control of the total governmental sector, and particularly of total tax burdens, means that tax systems cannot be designed and harmonized without regard to the different revenue-raising demands placed on them by the various governments. This in turn means that spending and taxing powers cannot be treated independently in any ultimate sense. This, therefore, suggests a concentration by the policy co-ordination committee on:

- (a) In line with 23(a) above, the development of agreed spending priorities as a basis for developing:
 - mechanisms for containing total government spending, particularly when a policy of fiscal restraint is required; and
 - allocating scarce revenue resources according to the division of priority-spending responsibilities.
- (b) The development of common criteria and conventions in the development of federal and provincial-municipal tax systems as a basis for consistent treatment of tax resources, and avoidance of interprovincial tax competition and extraprovincial taxation.

A Federal-Provincial Tax Commission

26. The second type of new institutional arrangement required in the area of federal-provincial fiscal and financial co-ordination concerns the need for a high degree of co-operation in the administration of tax systems on a continuous basis, as suggested in paragraph 20 above. While the main thrust of Ontario's tax reform program is in the direction of a rationalization of provincial-municipal financial structures, it has been explicitly

designed to allow the maximum possible degree of harmonization and co-operation with the federal government in jointly occupied tax fields. The problems of federal-provincial compatibility in tax design and use would most properly be the concern of the overall ministerial committee, as suggested under paragraphs 23 and 25 above. The detailed operational aspects of tax administration, however, would be better handled by a separate federal-provincial commission as suggested in the Ontario white paper.³ Basically, such a commission could serve two important functions.

Overall Tax Supervision

27. The first function would be to provide a system for supervising federal and provincial municipal tax developments and practices in terms of their conformity to the common standards established by the ministerial committee on intergovernmental policy co-ordination. Apart from acting as a clearing-house of tax information, the commission could undertake analysis of the social and economic effects of tax policies and actions, particularly of their cross-jurisdictional implications. The commission could also be responsible for co-ordinating research on new tax proposals and options.

Tax Collection and Administration

28. Second, it would be appropriate for such a commission to be charged with the operational responsibility for administering specific federal-provincial tax collection agreements. Ontario's white paper suggests two types of collection agreements, namely :

- (a) *Standard Collection Agreements.* In the current constitutional fiscal framework, this would cover the administration and collection of revenues in such fields as corporate income, capital gains, estates and gifts taxation which might be assigned by the provinces to the federal government.
- (b) *Concurrent Tax Collection.* This would cover situations in which separate federal and provincial taxes could be administered through joint collection systems. Relevant examples here would be the joint administration of personal income taxation as suggested in the Ontario white paper, and provincial collection of certain federal commodity taxes.

29. The case of standard collection agreements presents no particular administrative difficulties beyond that of designing viable tax systems *per se*; for example, the problem of establishing an equitable and effective form of capital gains taxation. In the case of the taxes which Ontario proposes to consign to federal administration, however, Ontario would

³See *Ontario Budget 1969*, p. 57

need to be assured that the federal systems in each case were in the first instance appropriate to Ontario's overall tax policy and in the second instance that Ontario could effectively participate in subsequent changes and developments.

30. The difficulties in establishing concurrent collection systems would clearly be more formidable. On the one hand, there is no body of Canadian experience to draw on in this area. But, on the other hand, the advantages in terms of administrative and compliance costs are likely to be considerable. In personal income taxation, much depends on the degree of compatibility between federal and provincial systems in terms of income bases, income-class structures and progressive rate schedules. In the case of Ontario, the tax reform program announced in the white paper calls for the establishment of a provincial personal income tax system for 1971. At the present time work is proceeding on the design of the new tax system and building the necessary administrative structure. However, this schedule allows ample scope for negotiations with the federal government on the establishment of a concurrent collection system, given the anticipated publication of the federal white paper in June of this year.

31. Clearly, it would be premature to attempt to offer any definite proposals on the concurrent collection of the federal and Ontario personal income taxes until the federal government's proposals are published. At this point, however, it might be useful to make a few general observations on this question.

32. First, it has been suggested by some that changes in provincial income taxes—particularly in the form of changes in the income base rather than in across-the-board rate increases—would complicate the present federal system to an unworkable degree. The proliferation of income tax consulting firms in recent years and the legendary proportion of incorrectly filed returns, however, suggests that the existing system is already too complex for the majority of taxpayers. This suggests a basic need to rationalize the income tax system, quite apart from the possible effects of a separate Ontario personal income tax.

33. Second, depending on the actual differences between the proposed federal and Ontario systems, it is likely that both would require a largely common set of data on the individual taxpayer concerning earned income, family size, expenses, domicile, and so on. The main problems and difficulties would arise in requiring taxpayers to make the two sets of calculations necessary to apply the two tax systems to the common data base.

34. The implication of these two observations is that much of the difficulty both with the existing income tax system and the administration of separate federal and provincial systems lies in the principle of self-

assessment. If the requirement of taxpayer self-assessment were abandoned a completely new range of administrative possibilities appear. If, for example, the taxpayer were required only to submit to the central agency the basic information required by the federal and provincial systems, it could conceivably be subjected to the necessary manual verification and controls and to computerized processing in each case. The taxpayer could then be notified of his final assessment and provided with a detailed print-out of the calculation of each tax. The assessments and print-outs could be designed to provide visual emphasis to the differences between federal and provincial tax burdens.

ALTERNATIVE METHODS OF TRANSFERRING FEDERAL TAX REVENUES TO THE PROVINCES¹

Introduction : The Background to Current Negotiations.

1. Economic theory recognizes that government expenditures have two main effects on economic activity generally :

- (a) In the area of short-run stabilization, conventional Keynesian theory views them as a component of total effective demand which can be consciously manipulated through deficit or surplus budgeting to offset inflationary or deflationary changes in the level of private demand ; and
- (b) In the area of longer-run growth, they are commonly regarded as important for the creation of the necessary social environment and infrastructure of essential public services and capital facilities.

On both counts, a steady growth in government expenditure to match the growth of the private sector can thus be seen as one of the main requirements for achieving a high and stable rate of economic growth in Ontario and Canada generally. Consequently, any significant decline in the relative importance of the government vis-a-vis the private sector might involve (a) a decline in the effectiveness of anticyclical fiscal policy as a function of reduced fiscal leverage, and (b) a failure to provide social capital required to facilitate increases in private economic activity.

2. The basic problem involved in securing the required growth of public expenditures in Canada lies in the imbalance which exists in the distribution of revenue sources and expenditure responsibilities between the federal and provincial governments. The form of this imbalance is well known :

- (a) The federal government occupies and dominates what are commonly called "growth-tax" fields : primarily, personal and corporate income taxation ; while
- (b) The provincial governments, and their subordinate municipal authorities, are responsible for the major "growth" fields in public expenditures : education, health, highways and other localized public services and facilities, all of which tend to grow proportionately or more than proportionately to the growth of the economy generally.

¹Presented to the federal-provincial Continuing Committee on Economic and Fiscal Matters, Mont Gabriel, Quebec, September 1966.

3. This imbalance has resulted in two main adverse developments, which determine the context within which the renegotiation of federal-provincial fiscal arrangements must be discussed. These are :

- (a) A growth in federal control over the disposition of provincial funds through :
 - the return of revenues under various conditional grant schemes by which it intervenes and participates in the determination of provincial-municipal expenditures in areas normally within their exclusive jurisdiction ; and
 - transfer payments and equalization grants, by which it is able to change the interprovincial balance of public and private expenditures.
- (b) A growth in provincial-municipal revenue shortages, which in the more prosperous provinces has been accentuated by the implicit loss through interprovincial equalization transfer of funds which would otherwise have been available to them. This in turn has resulted in :
 - a pronounced increase in the absolute and relative volume of direct and indirect long-term debt operations by provincial and municipal governments ; and
 - a forced growth of independent provincial and municipal taxation of goods and services.

4. This situation has led to a general demand by the provinces for the transfer of more federal taxing powers or tax revenues to increase both their fiscal capacity and autonomy. It can now be taken for granted that the forthcoming federal-provincial tax negotiations will involve a significant revenue re-allocation to the provinces. This in turn gives rise to a series of questions relating to the methods and consequences of such re-allocations. For example :

- (a) How should funds be allocated to the provinces ? Should it involve both increased provincial fiscal capacity and autonomy ? That is, to what extent should the federal government participate in the determination of provincial-municipal expenditure standards and patterns ?
- (b) What are the implications of increased provincial fiscal leverage and autonomy for the conduct of effective fiscal policy generally ? Does it involve a decrease in the federal government's ability to exercise effective fiscal control ? And if so, how can funds be re-allocated without this effect ? Or, what alternative systems can be substituted to exert required fiscal control ?

Alternative Methods of Revenue Transfer

5. There are three main alternative methods by which revenues may be transferred to the provinces ; namely through²

- (a) The extension of conditional grants,³ under which
 - the federal government acts as tax setter and collector, and
 - exercises a large measure of implicit control in the determination of provincial-municipal expenditures ;⁴
- (b) The extension of unconditional grants or general tax abatements,⁵ under which
 - the federal government acts as tax setter and collector, but
 - exerts no control over provincial-municipal expenditure ; or
- (c) The federal and provincial governments abandoning the system of tax sharing and resorting to independent tax setting and collecting (possibly after some initial adjustment in federal rates to make implicit room for the provinces),⁶ under which each authority is responsible for raising the revenues required to finance its constitutionally determined expenditures.⁷

6. This range of alternative methods of transferring revenues can be seen to involve the fundamental question of the extent to which governmental tax systems and expenditure patterns should be standardized and integrated in Canada under the tutelage of the federal government. On this question, it is commonly recognized that while there are undoubtedly areas in which provincial spending programs should be standardized, there is also a tendency for the federal government to seize political initiative and intervene in areas of provincial jurisdiction simply as a function of its superior financial capacity and power. The danger inherent in this latter

²The following classification is not meant exactly to describe the existing range of schemes. Rather, it is intended to distinguish between the ways the following two factors may appear separately or together : (a) federal control of provincial expenditure patterns and standards, and (b) federal government control of tax rates and collections.

³This type would correspond to such existing schemes as program block grants, cost sharing and matching, and grants-in-aid.

⁴Federal control is based on (a) the conditions of federal participation, and (b) the fact that the provinces must commit their own resources in order to receive federal funds.

⁵This type refers to the transfer of funds from the federal government to the provinces without any stipulation as to the way they are used.

⁶This type is often referred to as the "open-ended box" tax system and is hereafter referred to as independent taxing.

⁷This system could, of course, involve the federal government continuing as a centralized tax collector on behalf of the provinces. This would appear to be a useful means of maintaining intergovernmental tax uniformity. However, it is doubtful whether the federal government would be always prepared passively to collect provincial taxes when it has no control of rates. For this reason, it is believed that the continuation of the existing collection agreement would be feasible only during the transition from joint to independent taxing.

case is that federal and provincial resources may be committed to a system of national programs which do not accurately reflect interprovincial differences in problems and requirements.

7. In recognition of this danger, it now appears to be generally agreed that the range of federal conditional grant schemes should be confined (and reduced) to those areas in which there is an obvious "national" interest in uniformity, and in which provincial requirements and conditions are also sufficiently similar to allow the efficient application of common expenditure standards. By deduction, this suggests that the bulk of "surplus" revenues⁸ should be returned to the provinces in ways which allow them the maximum degree of freedom in determining their own expenditure priorities to meet their own peculiar requirements. In these terms, the required flexibility in provincial spending patterns could be achieved either by the expansion of unconditional tax abatements, or by resorting to independent tax-raising operations (i.e. methods b and c under paragraph 5).

8. However, while the provinces might be indifferent to these two methods of achieving increased financial capacity and autonomy, *per se*, the choice between them has been seen to involve significantly different consequences for fiscal policy in Canada. Federal representatives emphasize that effective nation-wide fiscal policy depends on the federal government's occupancy of general and specific tax fields being sufficient to allow it to control the total structure of Canadian taxes and quickly alter its own budgetary contribution to aggregate demand. In these terms, it is argued that existing tax rates in the present areas of explicit or implicit tax sharing could not allow significant increases in tax abatements to the provinces without reducing the federal government's leverage to the point that it seriously endangers its ability to undertake effective fiscal action in the face of adverse economic developments. In particular, it is claimed that its share of the existing personal income tax rate cannot be reduced below 50 per cent. On these grounds, it is suggested that the federal and provincial governments should henceforth resort to independent taxing operations (something like method c) as a means of increasing provincial revenues without reducing federal fiscal capacity and flexibility.

9. Because of the attention which is now being given to the idea of independent federal-provincial financing, the remaining parts of this paper are devoted to a general examination of some of the difficulties and implications of such a system. In particular, attention is given to: (a) the question of what constitutes required federal tax occupancy, especially as it determines the extent to which the federal government could vacate tax fields in favour of the provinces as an initial adjustment prior to the commencement of independent taxing operations; and (b) the problem

⁸'Surplus' revenues refers to those funds which are raised by the federal government, in excess of its own-account and interprovincial equalization requirements, and which are currently transferred to provincial governments in one form or another.

of the possible development of intergovernmental tax competition and conflict.

Total Required Federal Tax Occupancy

10. The federal government's required total occupancy of any given range of tax fields may be said to have two main components. The first is the tax occupancy it requires for anticyclical budgetary purposes; while the second is the occupancy needed to finance its own-account expenditure operations.⁹ As already mentioned, the federal government's advocacy of independent federal-provincial revenue-raising operations is, presumably based on its belief that such a system would allow it to meet both sets of requirements. But since the present problems in federal-provincial financing stem from a shortage of revenue and are thus indicative of a general need to raise tax rates, one of the main factors which will determine whether and on what terms the provincial governments will agree to independent taxing (and, indeed, to the continuation of existing arrangements), is how the politically onerous task of raising taxes will be divided between the two levels of government. It depends on there being some satisfactory initial reduction in the federal government's occupancy of existing tax fields (or rates) to make implicit room for the provinces before they are forced to develop new tax fields or resort to "double taxation" in areas of concurrent federal-provincial taxation.¹⁰ More specifically, agreement will likely hinge on the extent to which the federal government is prepared to vacate the all-important personal income tax field *beyond the 50 per cent which is directly or indirectly already allocated to the provinces*.¹¹

11. In other words, it may be said that from the provincial standpoint a greater part of existing federal revenues must be re-allocated to the provinces *irrespective of the future form of federal-provincial financing*. This in turn focuses attention on the crucial question of the extent to which the federal government's share of total governmental taxes can be reduced without hindering its ability to meet its expenditure responsibilities and to exercise fiscal control of the economy. In this connection, the remaining part of this section is given to an examination of, first, the separate properties of each of the two components of required federal tax occupancy, and

⁹It is also said that a third factor involved in the determination of federal tax occupancy is the need for it to control the "form and structure" of taxes. This is, however, discussed on pp. 35-39 below.

¹⁰It is important to note that, throughout the following, attention is focused entirely on the need for the provinces to make net revenue gains over and above any funds they receive under or in lieu of cost sharing.

¹¹The figure 50 per cent of the personal income tax is based on (a) the regular 28 per cent tax sharing abatement made to all provinces, (b) the additional 19 per cent abatement to Quebec in lieu of its participation in a number of shared-cost programs specified in the Interim Arrangements Act, and (c) the further 3 per cent abatement to Quebec in lieu of payments under the federal Youth Allowances Program. It is therefore assumed that items b and c are implicitly available to the other provinces also.

second, the relationship between them in determining total required federal tax occupancy.

12. Federal Tax Occupancy and Effective Fiscal Policy. The first component of the federal government's required total tax occupancy involves the role of changes in tax yields and rates (along with changes in government spending and debt operations) as important parts of anti-cyclical and growth policy. The connection between federal tax occupancy and fiscal policy leverage is discussed on the basis of the following general federal assumptions:

- (a) That total governmental (federal plus provincial-municipal) tax rates and expenditure programs are set to produce a balanced sectoral budget at some target-employment level. This involves the familiar idea that as aggregate economic activity, incomes and employment vary from the desired level, budgetary deficits or surpluses will begin to appear in the governmental sector to exert countercyclical pressures on the system as a function of built-in stabilizers and discretionary tax and expenditure changes.
- (b) That the operation of anticyclical fiscal action is confined entirely to the federal government—budgetary surpluses and deficits appear only in the federal government's part of total governmental accounts.
- (c) And that, consequently, provincial governments follow "neutral" budgetary practices, in the sense that automatic changes in their revenues are matched by expenditure changes to maintain balanced budgets at all levels of economic activity.
- (d) That while total governmental revenue equals expenditures at target employment (assumption (a)), the distribution of revenues nevertheless results in surpluses and deficits in the federal and provincial-municipal subaccounts respectively. In other words, this assumption allows the problem of a *general deficiency* of governmental revenues to be separated from the problem of reconciling provincial financial needs with federal fiscal leverage requirements in the *distribution of total revenues*.

13. Given these general assumptions, the question of the effect on fiscal policy of a reduction in the federal government's share of a given package of federal-provincial tax fields, as an initial adjustment before the commencement of independent federal-provincial financing, is examined in two stages. The first stage is based on the following specific assumption:

- (e) That the federal government's occupancy of a given package of tax fields—mainly personal and corporate income and sales taxation—is reduced in an "across-the-board" manner, so that the relative contributions of specific taxes to its total tax revenue are not changed.

14. The importance of assumption (e) is that the vacation of tax fields by the federal government would mean that its total tax revenues would be reduced without changing the sensitivity (or elasticity) of revenues relative to changes in the level of economic activity or national income. This in turn means that the maintenance of effective federal fiscal action would not involve any increase in the absolute size of federal deficits or surpluses required to produce any given change in its own or total governmental (i.e. federal and provincial) budgetary impact on aggregate demand (G.N.E.).¹² The only change would be that as its own share of total governmental spending and tax revenues declines, the creation of *given* total governmental deficits or surpluses would involve an increase in the *relative* size of changes in federal revenues vis-a-vis expenditures.¹³

15. In these terms, it can be seen that a reduction in the federal government's share of the total governmental account at the full-employment level does not necessarily endanger its ability to exercise effective fiscal action. If required fiscal leverage is defined simply as the ability automatically to incur certain deficits and surpluses, federal fiscal policy would be weakened only at the point at which required deficits and surpluses became greater than 100 per cent of its calculated full-employment budget. This suggests that—again from the standpoint of effective fiscal policy only—the federal government's occupancy of a given tax package can be reduced much below the prevailing level. For example, if deficits of 15 per cent in the total governmental sector are normally required to stabilize the economy at the desired employment-target level in the face of minor cycles, then the federal government's occupancy could be reduced to something like 15 per cent.¹⁴

16. Two further points may be made in elaboration of this general rule. First, any danger to the effectiveness of federal fiscal policy resulting from required deficits and surpluses (i.e. greater than, say, the "normal" 15 per cent) becoming greater than the federal government's target-employment budget, *could still be countered by discretionary tax and expenditure changes*. Second, the danger of reducing effective fiscal action through a reduction in federal tax leverage would be further offset if assumption 12 (c) were realistically relaxed and allowance made for complementary and

¹²An important corollary of this is that it would neither change the amount of any associated federal debt operations, nor the required Bank of Canada support.

¹³For example, with an 80-20 federal-provincial division of total governmental revenues at the calculated balanced-budget level, a 15 per cent deficit in the total governmental sector would involve a 19 per cent deficit in the federal government's account. A change to a 50-50 federal-provincial division would mean the same total governmental deficit would involve a 30 per cent federal deficit.

¹⁴Again, this is only in terms of its ability to exercise fiscal control. However, as stated at the beginning of this section, this factor is only one component of total required federal tax occupancy. And it is obvious that the second component—its own-account and interprovincial equalization transfers—might demand a larger tax share. This latter factor is discussed at a later point in this section.

concomitant deficits and surpluses occurring automatically in the provincial-municipal account, according to the *pro rata* distribution of total governmental revenues.

17. In the second stage the following assumption is substituted for assumption 13 (e) :

- (f) That as the federal government's tax occupancy is reduced, the balance of its occupancy of specific tax fields is changed.

The effects of changing the relative importance of specific taxes in the federal government's total tax package would likely be to make its total tax receipts proportionately more or less sensitive to changes in national income. On the other hand, if the federal government were to become more reliant on personal income taxes by vacating, say, sales tax fields, total federal tax revenues would become more sensitive to national income changes, because income tax receipts are commonly held to change more than proportionately to changes in taxable income. On the other hand, a heavier relative federal reliance on sales taxation could work to decrease the sensitivity of total federal tax receipts to changes in economic activity, to the extent that such tax receipts change less than proportionately to changes in national income.

18. Any increase in the variability of total federal tax revenues—because of a greater reliance on income-sensitive taxes—would tend to have two main effects in the area of anticyclical budgeting :

- (a) It would increase the automatic-stabilizer properties of the federal budget by producing greater absolute and relative federal surpluses and deficits as economic activity and national income move from the desired full-employment balanced-budget level ; and
- (b) It would reduce the extent of discretionary tax-rate changes required to add to or reduce automatic changes in the federal government's revenue-expenditure balance.

19. Alternatively, any decrease in the sensitivity of total federal tax revenues—because of a greater reliance on income-insensitive taxes—would :

- (a) Reduce the extent of automatic changes in federal revenue-expenditure balance, in the form of smaller absolute and relative deficits and surpluses, as a function of given expenditure programs, tax rates and national income changes ; and
- (b) Increase the extent of discretionary changes in tax rate changes required to augment or mitigate automatic budgetary changes.

20. This discussion of the effects of changes in the overall income-sensitivity of federal tax receipts does not materially affect the generalization

in paragraph 15 concerning the limits to reductions in total federal fiscal leverage. Its importance is that it suggests that if provincial revenue requirements are to be met by changes in provincial occupancy of specific tax fields rather than by across-the-board adjustments over a group of taxes, from the point of federal fiscal policy, it would be better done by increasing provincial occupancy of income-insensitive tax fields.

21. However, while such an assignment of tax fields between the federal and provincial governments might thus appear as a suitable way of meeting provincial revenue requirements without detracting from federal fiscal policy, it would nevertheless involve a number of difficulties and objections from the provincial standpoint. For example, to the extent to which the provinces became disproportionately reliant upon nongrowth tax yields it might merely tend to recreate the problem which any re-allocation of tax fields is presumably intended to eliminate: namely, that of recurring provincial deficits caused by the greater secular growth of expenditures vis-a-vis revenues. If such a division of tax fields were put into effect and rigidly maintained, the provinces would be forced over time to increase their rates progressively in order to maintain an adequate growth in yields. This in turn could lead to distortionary effects on the form and balance of the complete structure of governmental taxation in Canada as it affects different types of tax-paying economic activities. Thus, in order to maintain some semblance of a balanced tax structure and the anticipated growth of provincial expenditure, it is apparent that the vacation of tax fields by the federal government would need to involve balanced provincial gains of both growth and nongrowth revenue sources.

22. *Federal Tax Occupancy and Own-Account Revenue Requirements.* The second component of the federal government's required total occupancy of a given range of tax fields was held (in para. 10) to be the revenue it needs to allow it to meet its constitutionally determined expenditure responsibilities and to finance its role as the agent for interprovincial fiscal equalization. In this connection, the provincial interest lies in achieving a re-allocation of total governmental revenues between the two levels of government in a manner which better matches the division of total governmental expenditure responsibilities. However, while the direction of the required re-allocation of total governmental revenues is readily apparent, there are a number of important questions which should be considered in determining the extent and the form of the adjustment and in defining the federal government's own-account revenue requirements. At this point attention is confined to two of them.

23. The first question concerns the extent to which existing total governmental revenues should, in general, be re-allocated in a situation in which the total governmental sector as a whole is underfinanced. Briefly, the provincial interest requires that any re-allocation should not be aimed

merely at eliminating obvious inequities such as, say, surpluses in the federal subaccount. Rather, where there is a general revenue shortage,¹⁵ the federal share of total governmental revenues should be reduced *below* its own-account requirements in a manner which equalizes the relative effort required by the two levels of government in subsequently meeting their residual revenue needs by increasing taxes or resorting to debt financing.¹⁶

24. Crucial to the idea of equalizing relative federal and provincial tax raising and debt-financing burdens is the second question concerning the re-allocation of specific tax fields. Again, the point here is that there are wide differences in the growth characteristics of various types of taxes, in terms of changes in their yields in relation to changes in national income. This suggests that specific tax fields must be allocated between the federal and provincial governments in a way which produces a balanced "mix" of growth and nongrowth taxes in their respective tax package in order to give their total revenues the growth potential needed to match the anticipated growth of their total expenditures.¹⁷ This, in turn, gives rise to two observations in terms of the highly prized personal income tax field. First, the projected more-than-proportionate rise in provincial-municipal expenditures relative to the yield of existing revenue sources or, for that matter, relative to federal own-account spending, indicates that provincial revenue gains must include significant increases in the personal income-tax field.¹⁸ And secondly, the federal government's occupancy should not be determined by some arbitrary standard, but in terms of that needed to give its total revenues the growth elasticity needed to maintain a certain relationship to expenditure increases. It is obvious that a great deal of research is necessary before it is possible to determine what should be the correct federal-provincial occupancy ratio in the personal income tax field. Nevertheless, it would appear to be reasonable to speculate that it is highly unlikely that the economically correct ratio would happen to exactly coincide with the proposed 50-50 division.

¹⁵That is where either provincial-municipal deficits are greater than federal surpluses, or where existing tax rates produce deficits in both subaccounts.

¹⁶In the area of debt financing, 'relative effort' should be interpreted in a way which effectively accounts for differences in the difficulties encountered by federal and provincial-municipal governments in obtaining new debt funds in the capital market, and in the debt levels they can tolerably maintain.

¹⁷The effects of changes in the relative importance of income-sensitive and insensitive taxes in the federal government's total tax package on its ability to generate automatic surpluses and deficits was discussed in relation to short-run cyclical disturbances in paragraph 17-19 above.

¹⁸That is to avoid a long-run tendency toward progressive increases in debt financing by provincial governments in relation to their total budgets. In this connection, it is important that funds obtained from the Canada Pension Plan should be regarded merely as substitutes for provincial borrowing in the private capital market rather than as additions to provincial tax revenues, regardless of whether such "forced savings" are generally viewed by the public as a form of taxation.

25. Federal Fiscal Policy and Own-Account Requirements Combined.

So far in this section attention has been given to a separate examination of the federal government's tax occupancy requirements for the purpose of (a) exercising effective anticyclical fiscal policy and (b) financing its own expenditure operations. It remains at this point to discuss briefly the way in which these two components or factors combine to determine the federal government's total required tax occupancy.

26. On this question it may be simply said that the two components should be viewed as representing concurrent federal functions. As such, the share of any one or group of tax fields which the federal government requires in order to exercise these functions *should not be determined by the total value of the two components but by the value of the largest one*. That is whichever component requires the greatest tax share will automatically provide sufficient means to "accommodate" the smaller component. Thus, if the tax occupancy required by the own-account component were the greater it would provide the federal government with a full-employment budget large enough to accommodate the automatic budgetary changes required to deal with minor inflationary and deflationary disturbances. On the other hand, however, it is apparent that if the tax occupancy required for fiscal policy purposes is greater than that needed to finance federal own-account expenditures there would be a tendency for the federal government to run surpluses at target-employment. This in turn suggests that there would need to be a "residual-adjustment" transfer of such surpluses to the provinces (i.e. to reduce their tax efforts), in order to prevent either the appearance of deflationary surpluses in the total governmental account at full-employment or the federal government seeking new expenditure outlets merely for the purpose of disposing of such surpluses.

Competitive Tax Systems

27. As mentioned in paragraph 9, the second difficulty involved in independent federal-provincial taxing operations concerns the possible development of significant differences in government tax structures. Theoretically, of course, interprovincial tax differentials might be viewed as logical companions to different expenditure patterns in dealing with differing regional requirements and conditions. For example, alongside differences in provincial expenditure priorities, variable tax rates might be used to produce (a) different incentives and disincentives to particular types of economic activity and consumption, and (b) overall budgetary surpluses and deficits at the provincial level. On the latter point, higher income taxes and budget surpluses might be appropriate to, say, Ontario to curb inflationary tendencies and reduce private consumption to make room for required government spending. Weaker economic conditions in, say, the Maritimes might suggest lower taxes and deficits in order to

add government spending to private consumption and investment to exert the maximum upward pressure on effective demand.

28. On the other hand, doubts may be raised about the provinces' ability and willingness to introduce positive fiscal action along these lines. On the matter of ability, one might question whether provincial governments, as yet, possess the required technically trained personnel and policy apparatus. On the question of willingness, two points might be made. First "positive" fiscal action would involve rather profound changes in the philosophy and practice of provincial budgeting. Here one is reminded of the legendary persistence of balanced-budget dogma among national governments and the difficulty in securing even rudimentary commitments to the basic principles of Keynesianism. Second, and more important, there is the danger of provincial tax autonomy leading to the development of tax systems which consciously or unconsciously work to compete for economic activity. For example, in terms of the example outlined above, it is likely that Ontario would be reluctant to deflate its economy if it involves the loss of activity to the other provinces. It is more likely to let its economy expand with the hope of attracting resources from the other provinces, in order to relieve production bottlenecks, until the federal government was forced to instigate general deflationary measures.

29. In addition to the problem of interprovincial tax competition, there is also a danger that independent provincial tax operations might lead to similar conflicts between the provincial and federal governments. It is not difficult to imagine numerous ways in which changes in provincial taxes might work directly or indirectly to nullify federal tax changes. For example, it is not inconceivable that, if the federal government decides to reduce taxes to encourage economic activity generally or specifically, the provinces might move to "take up the slack" by simultaneously raising theirs as a means of increasing revenues in a way which reduces possible political repercussions.

30. The possibilities of intergovernmental tax conflicts suggest that the advantages of independent taxing as a means of reconciling provincial revenue requirements with the need to maintain the federal government's flexibility in its fiscal policy actions may well be illusory. One of the values of the present system of tax-sharing is that under the leadership of the federal government there has evolved since 1941 a series of "rules and procedures" which have worked to maintain some consistency in the operations of the eleven governments in a number of tax fields. In place of this admittedly "uneasy truce" it is conceivable that all semblance of a co-ordinated national tax structure could gradually break down under independent taxing as the separate tax systems of the federal and provincial authorities evolve along different lines. Or worse, in recognizing the dangers of competitive taxing, it is possible that taxes will become fossilized because of the unwillingness of any government to precipitate

a "tax war". It is perhaps ironical, therefore, that to avoid such dangers a highly formal mechanism for intergovernmental co-operation and liaison would have to be established which would very likely prove to be more unwieldy than the existing system.

31. In a way it would appear that the federal government has recognized these difficulties in its insistence on retaining a minimum of 50 per cent of the existing personal income tax rate in order to allow it to "control the form and structure" of the tax. However, while its objective is sound in this instance, there are a number of weaknesses in its approach.

32. The first problem deals with the implicit assumption that a "uniform and basic" federal income tax will effectively determine the form of provincial income taxes in the absence of formal federal-provincial tax-structure agreements. It is quite conceivable that this would indeed have the desired effect of imposing a pattern from which the provinces would be unwilling to break. However, as emphasized previously, it is also the case that in holding the line at 50 per cent the federal government would be able to make only nominal concessions to the provinces prior to the commencement of independent taxing which would leave the provinces no option but to proceed with significant increases in their income taxes. Of course, if increases in provincial rates were imposed as additions to existing rates without changes in the form of the tax, the effect would be merely to raise the total level of income taxation (federal plus provincial) in each province in a way which would make interprovincial differences readily apparent to taxpayers. However, it is also possible that the provinces might seek to veil income tax increases by varying the tax structure itself. Then successive changes in the structure of provincial income taxes, designed to increase the effective rate or level of taxation, could in time lead to the development of two parallel and disassociated income tax systems, with the federal government's control of the one being of no particular importance in terms of any effective control of the other.

33. The second difficulty involves the connection between the federal government's occupancy of the income tax field defined in terms of 50 per cent of the existing tax rate and its ability to control the form and structure of the total governmental income tax over time. It has already been suggested that the anticipated rapid rise in provincial-municipal expenses will require tax increases. In particular, it was said that the need to ensure that the growth of total provincial revenues matches that of expenditures implies significant increases in provincial tax rates in the personal income and other growth-tax fields. In these terms it is possible to see successive increases in provincial income tax rates resulting in a progressive reduction in the federal government's share of the total governmental rate over time. This latter possibility gives rise to two pertinent questions. First, does the federal government's ability to control the personal income tax structure depend on a continuous 50 per cent occupancy through time, regardless

of future changes in the total governmental rate? And second, is it envisaged that 50 per cent of the existing rate will enable control to be maintained through time, in the sense that it implicitly allows for a decline in the federal share of the total governmental rate?

34. Each of these alternative interpretations has a number of important implications. In the first case, if federal control depends on a continuous 50 per cent occupancy, successive increases in provincial rates will need to be "matched" by the federal government. The danger inherent in this situation is that if such increases in federal tax rates are not also concurrently justified by autonomous increases in federal expenditure requirements, there will be a tendency for surpluses to occur in the federal subaccount. As mentioned in paragraph 26, such surpluses could exert an undesirable deflationary pressure on the economy or could lead to the federal government developing new expenditure programs simply for the purpose of disposing of embarrassing surpluses. In the second case, where a federal 50 per cent occupancy of the existing personal income tax rate involves a once-and-for-all adjustment which allows for a possible decline in the federal share of the total governmental rate, there is a suggestion that in the initial stages, therefore, the federal government will enjoy an occupancy which is more than that needed for control purposes. Again, to the extent that this occupancy is not otherwise justified by its revenue requirements, it involves a denial of revenue-raising capacity to the provinces which could have been used to reduce provincial tax-rate increases.

35. Finally, the third and most serious weakness in the federal government's insistence on a minimum occupancy of the personal income tax field, is its implicit neglect of the other areas of concurrent federal-provincial tax operations. The point here is that the personal income tax is only part of the total structure of governmental taxation. This emphasizes that any rationalization of federal-provincial financing should be conducted in a way which involves a recognition of the interrelationships of at least the main constituent taxes of the total tax structure, both in terms of their roles as alternative sources of governmental revenue and their combined and separate effects on the level and form of private economic activity.¹⁹ In these terms, a piecemeal re-organization of specific taxes may be seen to create an almost infinite number of problems in federal-provincial financing. That is, since the arguments for federal control of the form and structure of the personal income tax can presumably be applied to other important tax fields, it is also likely that the same kinds of difficulties will be encountered in reconciling federal control with provincial revenue requirements. For example, if federal control requirements involve significant restrictions to provincial gains in the personal income tax field, might not similar factors

¹⁹The importance of considering the total range of federal and provincial concurrent and non-concurrent tax fields was, of course, recognized in the original terms of reference of the Tax Structure Committee, and in the establishment of the Carter Commission and provincial tax committees.

prevent the provinces from making compensatory gains in other tax fields? Or in the event of the federal government confining its attention primarily to the personal income tax field as the main vehicle for fiscal action, might not the denial of adequate provincial gains in that area lead to a bunching of provincial tax increases in other areas in a way which might unbalance the total structure of governmental taxes and counteract federal policy in the income tax field? And, if the federal government insists on primacy in such growth tax fields as personal and corporate income taxation, would concessions to the provinces in the areas of succession duties and liquor taxation be acceptable in view of their nongrowth characteristics?

Summary and Conclusions

36. These notes have been primarily concerned with the federal government's proposal that henceforth the federal and provincial governments should resort to independent taxing operations as a means of meeting their separate revenue requirements. In particular, attention was given to two main problems: (a) of securing a satisfactory re-allocation of existing tax resources between the federal and provincial governments prior to the commencement of independent taxing, in order to equalize their relative burdens in subsequently raising taxes and debt funds; and (b) of maintaining a co-ordinated total governmental tax structure and preventing the development of intergovernmental tax conflicts after the commencement of independent taxing.

37. While discussion of the first of these questions began with federal-provincial tax operations generally, attention inevitably turned to the personal income tax field in particular. This was because, on the one hand, significant gains in this growth tax field were held to be necessary to ensure that total provincial revenues increase proportionately to projected expenditure increases; while, on the other hand, the federal government's view of its required share of the existing income tax rate effectively means that it is willing to make only nominal concessions to the provinces.

38. However, the main conclusion to be drawn from the discussion of federal-provincial tax-occupancy and revenue requirements is that the personal income tax should not be treated in isolation from the other main sources of governmental tax revenue. That is, the division of the personal income tax field between the federal and provincial governments should be based on the occupancy they each require to give their total revenues the growth potential needed to match the anticipated growth of their own-account expenditures. Similarly, the occupancy the federal government requires for the purpose of effective fiscal action should be defined in terms of the overall budgetary changes needed to counter "minor" cyclical disturbances, and in terms of the specific role of the personal income tax in relation to economic activity over the various phases of the business cycle.

39. On this latter question of federal fiscal policy, it was emphasized that three main points should be borne in mind in defining the federal government's tax-resource requirements. First, its fiscal policy and own-account requirements should be viewed as concurrent rather than additive requirements. Second, the federal government is not solely responsible for anticyclical action, at least in the face of minor disturbances, because any given set of total governmental tax rates will automatically tend to produce complementary budgetary deficits and surpluses on a *pro rata* basis in the provincial subaccount. Third, any given allocation of tax resources would not reduce the federal government's ability to make discretionary tax-rate changes in the face of major cyclical tendencies.

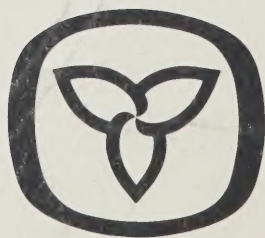
40. On the second question of the conduct of governmental finance after the commencement of independent taxation, attention was drawn to the possible development of intergovernmental tax competition and break-down of all semblance of a co-ordinated national tax structure. In this connection, several doubts were expressed about the federal government's claim that 50 per cent occupancy would allow it effectively to exercise control of the form and structure of the personal income tax. First, it says nothing about the *other* main tax fields which constitute the total structure of governmental taxes, particularly the extent to which restrictions to provincial gains in the personal income tax field might result in an unbalanced development of other fields. Second, it was doubted whether 50 per cent would effectively allow it to control the personal income tax itself. This latter was thought to be particularly likely if the provinces sought to veil increases in the effective tax rate by changing the structure of the tax, leading eventually to the development of a series of unrelated personal income taxes. Finally, there was the point that successive increases in provincial tax rates would reduce the federal government's leverage position over time, unless it "matched" such increases with increases in its own rate.

41. It is noteworthy that in the discussion of these matters no attempt was made to advance concrete proposals on how tax resources generally and specifically should in fact be shared between the two levels of government. The obvious complexity of the difficulties to be resolved would make such ambition pretentious. Indeed, the superficiality of the discussion may be taken as strong evidence that the re-organization of federal-provincial financing must be based on extensive research and analysis rather than on arbitrarily determined and imposed rules.

42. In conclusion, this examination of the possible implications of independent taxing might well be taken to suggest that any ill-considered change in the established form of federal-provincial financing could create more problems than it would solve. This would particularly be the case if it were viewed as an easy way of avoiding the necessity of resolving the difficulties of intergovernmental co-operation in jointly held tax fields. It was emphasized that the dissatisfaction with existing federal-provincial

tax-sharing arrangements is really due to the fact that the total governmental sector is underfinanced and that the resulting deficit is unequally divided between the two levels of government. As such, a continuation of the tax abatement system or resort to any independent financing method would not alter the fact that both taxes and provincial revenues have to be increased. Both methods involve an increase in the relative share by provincial governments of total governmental revenues to match their expenditure responsibilities, along with a corresponding contraction of the federal share to match its own-account and interprovincial equalization requirements. Similarly, in terms of required federal fiscal leverage, the same general rule would apply under both methods concerning the maintenance of the federal government's ability to incur required budgetary surpluses and deficits. The minimum size of its full employment budget for this purpose would be the same in either case. The main difference between the two methods is that under independent taxing the federal government might lose its ability to influence the complete structure of tax rates over several crucial tax fields and find its fiscal policies countermanded by unco-ordinated provincial actions.

43. On this question of the "natural" decline in the federal share of total governmental revenues, it is worth mentioning, finally, that any attempt by the federal government to maintain its existing relative share would have the effect of increasing total revenues beyond that justified by present revenue deficiencies. The extent to which this would tend to cause its revenues to exceed its expenditure requirements, is likely to involve two possibilities. First, it might seek new expenditure outlets to dispose of its surpluses, except, of course, where such surpluses might be useful for anticyclical purposes. The likely effect of this is merely to re-open the problem of federal encroachment on provincial jurisdiction. That is, if the increase in federal expenditure is justified, the provinces are likely to press for further transfers of both the revenues and functions involved. Secondly, if the federal government did not thus seek to dispose of its surplus revenues, the result would be the appearance of large and persistent federal surpluses at the full-employment level which might well work against full employment ever actually being attained.



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